

# IRC §42, Low-Income Housing Credit - Part VI Applicable Percentage

**Revision Date** - August 11, 2015

**Note:** This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

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## Chapter 14 Applicable Percentage

### Introduction

The applicable percentage is the discount factor used to account for the present value of the credit over the 10-year credit period. The taxpayer reports the applicable percentage on Form 8609-A, Annual Statement for Low-Income Housing Credit, line 5.

The applicable percentage is dependent on three basic factors:

- When the low-income building was placed in service, unless the taxpayer elects otherwise.
- Whether the housing is new or acquired existing housing.
- Whether the housing is federally subsidized.

For buildings placed in service in 1987, the applicable percentage was an annual rate of 9% for the 70% present value credit and 4% for the 30% present value credit. Although the present value of the credit is based on fluctuating interest rates and varies from month to month, the IRC §42 credit is commonly described as the "9%" and "4%" credits.

## **Topics**

- Law
- Federally Subsidized – Buildings Placed in Service Before July 31, 2008
- Federally Subsidized – Buildings Placed in Service After July 30, 2008
- Audit Issues and Techniques
- Adjustments to the Applicable Percentage
- Summary
- Reference

## **References**

To audit the applicable percentage, the following references are needed:

- [Guide for Completing Form 8823, Chapter 9.](#)
- [Former IRC §42\(i\) \(2\)](#), which is included as a reference at the end of the chapter.

## **Law**

### **Applicable Percentage Defined**

The applicable percentage is the factor which, when multiplied by the building's qualified basis, equals the credit allowable to the building.

For buildings placed in service during 1987, the first year the credit was allowable, the applicable percentage was fixed. Under former IRC §42(b) (1), the applicable percentage was:

- 9% for new buildings which were not federally subsidized for the taxable year, or
- 4% for new buildings which are federally subsidized for the taxable year, and existing buildings.

For buildings placed in service after 1987 and before July 31, 2008, under former IRC §42(b)(2)(B), the applicable percentage was prescribed by the IRS such that it would yield, over the 10-year credit period, an amount of credit having a present value equal to:

- 70% of the qualified basis of a new building that is not federally subsidized for the taxable year, and
- 30% of the qualified basis of (1) a new building that is federally subsidized for the taxable year or (2) an existing building.

As part of the Housing Assistance Tax Act of 2008, IRC §42(b) was amended and renumbered. For buildings placed in service after July 30, 2008, IRC §42(b)(1)(B) now provides that the applicable percentage is determined by the IRS such that the credit over the 10-year credit period will yield a present value equal to:

- 70% of the qualified basis of a new building that is not federally subsidized for the taxable year, and
- 30% of the qualified basis of all other buildings.

Congress amended IRC §42(b) (2) to provide a temporary minimum applicable percentage of 9% for new buildings that are:

- not federally subsidized,
- placed in service after July 30, 2008, and
- Received an allocation of credit before December 31, 2013.

### **Rehabilitation Expenses Treated as New Building**

Under IRC §42(e), rehabilitation expenses are treated as a separate new building qualifying for the 70% present value credit or the 30% present value credit if federally subsidized. See Chapter 9 for complete discussion.

### **Increases in Qualified Basis**

Under IRC §42(f) (3) (A), the credit associated with increases in qualified basis is computed using an applicable percentage equal to two-thirds of the applicable percentage that would otherwise apply to the building. See Chapter 13.

### **Applicable Percentage Determined**

Under IRC §42(b) (1), the taxpayer uses the applicable percentage for the earlier of:

- the month in which the low-income building is placed in service, or
- at the taxpayer's election, (1) the month in which the taxpayer and the state agency enter into an agreement as to the amount of credit to be allocated to the building, or (2) if the aggregate basis of a building and land upon which the building is located is financed 50% or more with tax-exempt bonds, the month in which the tax-exempt bonds are issued.

The election must be made no later than the fifth day after the close of such month and once made, the election is irrevocable. Procedures for making the election are outlined in Treas. Reg. §1.42-8. The election is binding if:

- it is in writing,
- is binding under state law on the state agency, taxpayer, and all successors in interest,
- specifies the types of buildings to which the credit applies,
- specifies the amount of credit allocated to the buildings, and
- Is dated and signed by the taxpayer and state agency during the month in which the requirements above are met.

See Treas. Reg. §1.42-8 for complete discussion.

### **State Agency Authority to Specify Applicable Percentage**

IRC §42(m)(2) requires state housing agencies to limit the amount of credit allocated to a project so that it does not exceed an amount necessary to ensure the project's financial feasibility as a qualified low-income housing project throughout the credit period.

This limit on the credit amount can be accomplished by limiting the applicable percentage used to compute the credit. Under IRC §42(h) (7) (D), the state agency making the credit allocation has the authority to specify the applicable percentage for the low-income building. The applicable percentage specified can be less than, but never more than, the applicable percentage otherwise prescribed.

### **Identifying the Applicable Percentage**

The IRS prescribes the applicable percentage as required under IRC §42(b) (1) (B). The present value is determined as of the last day of the first year of the 10-year credit period and by using a discount rate equal to 72% of the average of the annual federal mid-term rate and the annual federal long-term rate applicable under IRC §1274(d) (1) to the month and compounded annually, and assuming that the credit allowable under IRC §42 for any year is received on the last day of such year. See IRC §42(b) (1) (C).

The IRS publishes the applicable percentages on a monthly basis in the IRS Bulletin.

### **Applicable Percentage Documented**

The maximum applicable percentage is documented on Form 8609, line 2.

## **Federally Subsidized – Buildings Placed in Service Before July 31, 2008**

### **Federally Subsidized New Building Defined**

For new buildings placed in service before July 31, 2008, federally subsidized buildings are defined in former IRC §42(i) (2) (A). A new building is treated as federally subsidized for any

taxable year if, at any time during any taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under IRC §103 (tax-exempt bond), or any below market federal loan, the proceeds of which are or were used (directly or indirectly) with respect to the building or its operation.

Under former IRC §42(i)(2)(D), the term "below market federal loan" means any loan funded in whole or in part with federal funds if the interest rate payable on the loan is less than the applicable federal rate in effect under IRC §1274(d)(1) as of the date on which the loan was made. Such term shall not include any loan which would be a below market federal loan solely by reason of assistance provided under section 106, 107, or 108 of the Housing and Community Development Act of 1974 as in effect on December 19, 1989.

Under Treas. Reg. §1.42-3, effective for loans made after August 8, 1989, below market loans funded in whole or in part with funds from the Affordable Housing Program established under section 721 of the Financial Institution Reform, Recovery and Enforcement Act of 1989 are not, solely by reason of the Affordable Housing Program funds, below market federal loans under former IRC §42(i) (2) (D).

### **Election to Reduce Eligible Basis**

A new building is not federally subsidized if the taxpayer elected, under former IRC §42(i) (2) (B), to reduce eligible basis for purposes of IRC §42(d) by the principal amount of the loan or, in the case of a tax-exempt obligation, the proceeds of the obligation. The election is made on Form 8609, line 9a.

### **Federally Subsidized Construction Financing**

A new building is not federally subsidized if the tax-exempt obligations or below market federal loans used to provide financing during the construction of the building are, respectively, redeemed or repaid before the building is placed in service.

### **Loans from Community Development Block Grant Funds**

Generally, below-market loans made from Community Development Block Grant (CDBG) funds are below market federal loans. Exceptions include funds derived under section 106, 107, or 108 of the Housing and Community Development Act of 1974 (see IRC §42(i) (2) (D)). Additional exceptions are provided for under IRC §1400N(c)(6) for low-income buildings located in the Gulf Opportunity (GO) Zone, the Rita GO Zone, or the Wilma GO Zone if the low-income buildings were placed in service during the period beginning on January 1, 2006 and ending on December 31, 2010.

### **HOME or NAHASDA Assistance and the 40-50 Rule**

Under former IRC §42(i)(2)(E), assistance provided under the HOME Investment Partnerships Act (as in effect on August 10, 1993) or the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4101 et seq.), (as in effect on October 1, 1997) with

respect to any building shall not be characterized as a below market federal loan under IRC §42(i)(2)(D) if 40% or more of the residential units in the building are occupied by individuals whose income is 50% or less of area median gross income (40-50 rule).

If the building is located in a city described in IRC §142(d) (6), having five boroughs and a population in excess of 5,000,000, then 25% is substituted for 40%.

Buildings subject to the 40-50 rule are identified on Form 8609, line 6f.

If the building is subject to the 40-50 rule, then IRC §42(d) (5) (B) does not apply to the building. That is, the building does not qualify for the increase in eligible basis for buildings located in qualified census tracts or difficult to develop areas. On Form 8609, line 3b should not be more than 100%.

## **Federally Subsidized – Buildings Placed in Service After July 30, 2008**

### **Federally Subsidized New Building Defined**

For new buildings placed in service after July 30, 2008, federally subsidized buildings are defined in IRC §42(i) (2) (A). A new building is treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103 (tax-exempt bonds), the proceeds of which are or were used (directly or indirectly) with respect to the building or its operation.

### **Election to Reduce Eligible Basis**

A new building is not be categorized as federally subsidized if the taxpayer elects, under IRC §42(i) (2) (B) to exclude from eligible basis for purposes of IRC §42(d) the proceeds of such obligation. The election is made on Form 8609, line 9a.

### **Federally Subsidized Construction Financing**

A new building will not be categorized as federally subsidized if the tax-exempt obligations used to provide financing during the construction of the building identifies the building when the obligation is issued and the obligation is redeemed before the building is placed in service.

## **Audit Issues and Techniques**

### **Step 1: Reconcile Applicable Percentage on Form 8609**

Confirm that the applicable percentage is the correct percentage for:

- the month the building was placed in service as documented by the certificate of occupancy and on Form 8609, line 5, or

- If the taxpayer made an effective election, (1) the month in which the taxpayer and the state agency entered into an agreement as to the amount of credit to be allocated to the building, or (2) if the building is financed with tax-exempt bonds, the month in which the tax-exempt bonds were issued.

If the applicable percentage documented on the Form 8609 is less than the percentage under (1) or (2) above, then the percentage was limited by the state agency.

Also confirm that the applicable percentage on Form 8609-A, line 5, is the same as on the Form 8609.

Confirm that the applicable percentage correctly reflects the 70% present value credit for new buildings or the 30% present value credit for all other buildings.

## **Step 2: Consider Type of Finance**

If any federal subsidies (i.e., below market federal loans or tax-exempt bonds) are identified during the analysis of the taxpayer's financial resources, confirm that the applicable percentage value is correct for the 70% present value credit or 30% present value credit. See Chapter 10 for complete discussion.

## **Adjustments to the Applicable Percentage**

The following rules are applied when adjusting the applicable percentage.

- The adjustment will always be based on the applicable percentage for the month the building was placed in service or, if applicable, the month of the election under IRC §42(b) (1) [(A)] (ii). The taxpayer cannot make an election under IRC §42(b) (1) [(A)] (ii) during an audit.
- The applicable percentage can never be adjusted to be greater than designated by the housing agency allocating the credit.

## **Summary**

The amount of credit, over the ten-year credit period, is equal to the present value of either 70% or 30% of the qualified basis, depending on the characteristics of the housing.

The discount factor is known as the applicable percentage and is based on certain interest rates. Applicable percentages are published in the IRS Bulletin each month.

The applicable percentage is dependent on three basic factors:

- When the low-income building was placed in service. The applicable percentage for the month the building is placed in service is used unless the taxpayer elects otherwise. If the building is financed with tax-exempt bonds, the taxpayer may elect the month in which the tax-exempt bonds were issued.

- Whether the housing is new construction or acquired existing housing.
- Whether the housing is federally subsidized. The definition of "federally subsidized" differs based on whether the building was placed in service before July 31, 2008, or after July 30, 2008.

The state agency may lower the applicable percentage so that the credit allocated to a building does not exceed the amount necessary to ensure the building's financial feasibility as a qualified low-income housing project throughout the credit period. The state agency cannot increase the applicable percentage above the otherwise prescribed amount.

The applicable percentage for increases in qualified basis after the end of the first year of the credit period is two-thirds of the applicable percentage that would otherwise apply.

## Reference

### Former IRC §42(i) (2)

IRC §42(i) (2), as applicable to buildings placed in service before July 31, 2008.

(2) Determination of whether building is federally subsidized.

(A) In general. Except as otherwise provided in this paragraph, for purposes of subsection (b) (1), a new building shall be treated as federally subsidized for any taxable year if, at any time during such taxable year or any prior taxable year, there is or was outstanding any obligation the interest on which is exempt from tax under section 103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof.

(B) Election to reduce eligible basis by balance of loan or proceeds of obligations. A loan or tax-exempt obligation shall not be taken into account under subparagraph (A) if the taxpayer elects to exclude from the eligible basis of the building for purposes of subsection (d)--(i) in the case of a loan, the principal amount of such loan, and

(ii) in the case of a tax-exempt obligation, the proceeds of such obligation.

(C) Special rule for subsidized construction financing. Subparagraph (A) shall not apply to any tax-exempt obligation or below market Federal loan used to provide construction financing for any building if--(i) such obligation or loan (when issued or made) identified the building for which the proceeds of such obligation or loan would be used, and

(ii) such obligation is redeemed, and such loan is repaid, before such building is placed in service.

(D) Below market Federal loan. For purposes of this paragraph, the term "below market Federal loan" means any loan funded in whole or in part with Federal funds if the interest rate payable on such loan is less than the applicable Federal rate in effect under section 1274(d)(1) (as of the date



on which the loan was made). Such term shall not include any loan which would be a below market Federal loan solely by reason of assistance provided under section 106, 107, or 108 of the Housing and Community Development Act of 1974 (as in effect on the date of the enactment of this sentence [enacted Dec. 19, 1989]).

(E) Buildings receiving home assistance or Native American housing assistance.

(i) In general. Assistance provided under the HOME Investment Partnerships Act (as in effect on the date of the enactment of this subparagraph [enacted Aug. 10, 1983]) or the Native American Housing Assistance and Self-Determination Act of 1996 (*25 U.S.C. 4101 et seq.*) (as in effect on October 1, 1997) with respect to any building shall not be taken into account under subparagraph (D) if 40% or more of the residential units in the building are occupied by individuals whose income is 50% or less of area median gross income. Subsection (d) (5) (C) shall not apply to any building to which the preceding sentence applies.

(ii) Special rule for certain high-cost housing areas. In the case of a building located in a city described in section 142(d) (6), clause (i) shall be applied by substituting "25%" for "40%".